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AGENDA ITEM 6a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: AIM Allocation

II. PROGRAM: Alternative Investment Management (AIM) Program

III. RECOMMENDATION: Information

IV. ANALYSIS:

The target allocation to the AIM Program is 10% with a range of 7 - 13%. AIM's actual allocation as of July 31, 2008 stands at approximately 10.9%.

The allocation is the ratio of the market value of AIM's assets (or "the numerator") and the market value of CalPERS' total assets (or "the denominator"). The absence of symmetry between public and private market price movements is one of the reasons that ranges are used in the asset allocation process.

Staff has historically managed the AIM Program such that the allocation stayed within the policy ranges. There have been periods, however, where the allocation approached (or was projected to approach) the high end of the range, primarily during major downturns in the public markets (i.e., 2001/2002). During those times, Staff kept the Investment Committee apprised of the circumstances and proposed potential options that could be pursued.

For many years, AIM had difficulty reaching its target allocation. This was largely because of (1) strong public market performance that led to significant growth in the denominator and (2) favorable private equity market conditions that led to substantial distributions, which have the effect of diminishing the numerator.

In keeping with AIM's investor of choice strategy and the recommendations contained in the strategic review conducted by Pension Consulting Alliance, AIM made significant commitments in the 2006-2008 period to existing strategic relationships and created several very promising ones. The commitments were made in an effort to reach the target allocation while taking advantage of increased opportunities in the market. Commitments in this period averaged approximately $12 billion per year. AIM also disposed of a legacy portfolio in a secondary sale comprising approximately $2 billion in market value in 2008.

Because commitments are drawn down and then returned over time, some level of over-commitment is required to reach the target allocation. The practice in the industry is to commit 1.5 to 2 times the target level in order to reach the desired level of exposure. AIM conformed to this practice.

The recent decline in the denominator has had a pronounced effect on the allocation to AIM (known as the denominator effect). In addition, distributions have slowed considerably while draw-downs on commitments have continued, resulting in an increase in the numerator.

This has created a circumstance, not unexpectedly, that the allocation to AIM has exceeded its target, and it appears highly likely that it may exceed the maximum end of the range in the foreseeable future if the public markets do not recover and if distributions do not return to more normal levels. If the denominator remains at current levels (e.g., $231 billion as July 31, 2008), the allocation to AIM could reach approximately 12% at the end of this calendar year, based upon internal cash flow and market value projections.

The situation described above is not unique to CalPERS. Many public pension plans are experiencing the denominator effect with respect to their private equity allocations and are in the process of re-evaluating targets or ranges for the asset class.

The AIM Portfolio remains well diversified and solidly positioned to take advantage of current marketplace opportunities. Strategies have been developed and implemented in AIM that are allowing CalPERS to capitalize on substantial dislocations and other opportunities in the capital markets. These strategies, ranging from a large tilt to distressed securities to new and innovative clean energy investments, are expected to help diversify the CalPERS portfolio and generate superior risk-adjusted returns.

Asset Allocation Management

The AIM target allocation was increased to 10% with a range of plus or minus 3% when the Board adopted the new asset allocation policy targets in January 2008. Since then, the SIO-AIM and the SIO-Asset Allocation have discussed AIM's current and projected allocation. This was also discussed with the CIO at the time. The next ALM (Asset Liability Management) review is scheduled in 2010 when the policy targets will be reviewed and approved by the Board. In the interim, the investment policy for Asset Allocation Strategy includes a provision that "The CIO may also recommend to the Committee changes in the policy targets and ranges". Hence staff intended to inform the Investment Committee about these developments as part of an asset allocation review in the fourth quarter of 2008 and potentially recommend any changes to the range for AIM if warranted. In recent months pubic equity markets have continued to decline thus increasing the likelihood of AIM overweights and hence the need for this information item.

Path Forward

AIM Staff has been working on this issue with the SIO Asset Allocation and the Interim CIO. Pension Consulting Alliance (PCA), the Investment Committee's consultant on AIM, has been briefed.

Staff is planning to bring an agenda item to the Investment Committee this fall which provides an annual review of CalPERS' strategic asset allocation and ranges and any recommendations for needed changes.

Staff and representatives from PCA are available to answer any questions the Investment Committee may have.

V. STRATEGIC PLAN:

Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions and Goal IX, achieve long-term, sustainable, risk-adjusted returns.

VI. RESULTS/COSTS:

Additional legal negotiation and due diligence costs have been incurred as this policy is implemented for future investments. There may also be future investment opportunity costs that cannot be measured at this time.

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